Covid-19 & Monetary Policy's Credibility

What is the issue?

- Many unconventional measures are being taken to tackle the impact of ongoing Covid-led lockdown on the economy.
- However, these measures are to be taken without undermining the institutional frameworks.

What are the projections?

- Many economists are expecting the Indian economy to contract in the current fiscal year.
- These projections may worsen as it is still not clear when normalcy would be restored.

What are the measures taken?

- The Indian government has announced only a Rs 1.7-trillion package for the most vulnerable section of the population.
- The Reserve Bank of India (RBI) is doing the most of the heavy lifting.
- The RBI has **reduced interest rates**.
- It reduced the reverse repo rate outside the Monetary Policy Committee (MPC) cycle.
- The RBI has flooded the banking system with **liquidity**.
- Currently, the system has an excess liquidity worth about Rs.7 trillion.
- Some of the recent policy decisions of the RBI may end up creating longer-term risks.

Did increasing the liquidity help?

- The excess liquidity has not eased pressure in the financial system to the extent desired.
- Even when the MPC decided to keep the policy rate unchanged, the RBI increased liquidity in the system.
- Liquidity was increased to influence medium-term market rates.
- If the market rates are to be brought down, it should be through building a consensus in the MPC to cut policy rates with proper explanation.

What is the current situation?

- With so much liquidity in the system, market rates are now controlled by the RBI and not by the MPC.
- Undermining the MPC can **increase financial stability risks**, especially in uncertain times.

What could be done?

- In the given economic environment, the policymakers would need to take some extraordinary and **unconventional measures**.
- But it will also be critical to **protect the credibility of institutions**.
- If the markets believe that institutional structures and checks are not being undermined, the financial stability could be maintained.

Source: Business Standard

Quick Facts

Monetary Policy Committee (MPC)

- The **Finance Act, 2016** amended the RBI Act, 1934 to provide for a statutory framework for a Monetary Policy Committee.
- The MPC will **maintain price stability**, while keeping in mind the objective of growth.
- It would **fix the benchmark policy rate** (repo rate) required to contain inflation within the specified target level.
- As per the provisions of the RBI Act, out of the **six members** of MPC,
    1. Three Members will be from the RBI and
    2. Three members will be appointed by the Central Government.
- The meetings of the MPC shall be held at least 4 times a year and it shall publish its decisions after each such meeting.

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